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UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners: Robert G. Taub, Acting Chairman;
Nanci E. Langley, Vice Chairman;
Tony Hammond, Commissioner;
Mark Acton, Commissioner.

Institutional Cost Contribution
Requirement for Competitive Products **Docket No. RM2017-1**

COMMENTS OF FEDERAL EXPRESS CORPORATION

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Communications with respect to this document should be sent to:

M. Rush O'Keefe, Jr.
FEDERAL EXPRESS CORPORATION
Senior Vice President and General Counsel
Steven H. Taylor
FEDERAL EXPRESS CORPORATION
Vice President, Regulatory
3620 Hacks Cross Road
Memphis, TN 38125

Nancy S. Sparks
FEDERAL EXPRESS CORPORATION
Managing Director, Regulatory Affairs
Greg G. Stofko
FEDERAL EXPRESS CORPORATION
Senior Counsel
1700 Pennsylvania Avenue, NW
Suite 950
Washington DC 20006
Tel: 202 393 9286
Fax: 202 628 0654
nssparks@fedex.com
greg.stofko@fedex.com

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On November 11, 2016, the Commission established this docket inviting public comments on the minimum level of the institutional costs of the U.S. Postal Service ("USPS" or "Postal Service") that must be covered by the revenues of its competitive products collectively. Order No. 3624 (Nov. 22, 2016), 81 Fed. Reg. 28603 (Nov. 29, 2016). The Commission establishes the minimum level of institutional costs contribution for competitive products by regulation and must review its regulation at least once every five years. 39 U.S.C. § 3633(b). The current regulation, 39 CFR §3015.7(c), was adopted in 2012 and is now under review. Federal Express Corporation ("FedEx") respectfully submits the following comments in response to the Commission's invitation for comments.

1 The statutory standard: "appropriate share"

Section 3633(a) requires the Commission to adopt regulations which prohibit subsidization of competitive products by market-dominant products and ensure that each competitive product covers its costs attributable. In addition, the Commission must "*ensure that* *all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service*." Section 3633(b) says that every five years, the Commission must review its regulation "to determine whether the institutional costs contribution requirement under subsection (a)(3) should be retained in its current form, modified, or eliminated." In determining whether to modify an institutional cost contribution requirement the Commission should "consider all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or disproportionately associated with any competitive products." It is apparent from the statute that Congress envisioned the "appropriate share of the institutional costs" to be a third requirement in addition to the requirements that each competitive product cover its attributable costs and the avoidance of cross subsidy. But what additional costs should be covered by the revenues of competitive products collectively and to what end?

The term "appropriate share" does not appear in the version of the Postal Accountability and Enhancement Act ("PAEA") considered in regular legislative order by either the House or the Senate. It was introduced in the final iteration of the PAEA, H.R. 6407, a compromise between the House and Senate approved versions of H.R. 22. H.R. 6407 was developed by key members of the House and Senate behind closed doors without an explanatory conference report. It was introduced, debated, and passed by both houses of Congress in the final day of the lame duck session of the 109th Congress. During the abbreviated Congressional discussion of H.R. 6407, only one member mentioned the allocation of institutional costs. Senator Susan Collins, Chairman of the Senate Committee on Homeland Security and Governmental Affairs, declared that:

> The bill introduces new safeguards against unfair competition by the Postal Service in competitive markets, prohibits subsidization of competitive products by market-dominant products, and requires an allocation of institutional costs to competitive products. I note that we looked at competitive issues with UPS and FedEx, and I think we have come up with the right balance here. [152 Cong. Rec. S11675 (Dec. 8, 2006)]

In this summary statement, Senator Collins reiterated a theme often sounded by the authors of the PAEA during its decade-long gestation: that a primary objective of the bill was to give USPS enhanced commercial freedom to compete vigorously in competitive markets while also ensuring that USPS did not derive an unfair advantage from its operations in market dominant markets.[1] The "appropriate share" of institutional costs that should be charged to competitive products is the share is that the Commission deems appropriate to accomplish the basic objectives of the legislation.

In its most recent review of the "appropriate share" rule in 2012, the Commission lucidly explained the standard of appropriateness in Order No. 1449 as follows:

> *A primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace*. The Postal Service's competitors incur certain fixed operating costs. *If the Postal Service's competitive products were provided by a stand-alone enterprise, it too would incur fixed operating costs. The appropriate share requirement could be said to represent the fixed costs of the competitive enterprise* and should reflect the ways in which institutional resources are spent on the competitive enterprise. If the Postal Service's competitive products were not required to contribute an appropriate share towards the institutional costs of the enterprise, this could result in the market dominant

[1] The allocation of a share of institutional costs to competitive products is one of many provisions of the PAEA designed to ensure that "the Postal Service will compete on a level playing field, under many of the same terms and conditions as faced by its private sector competitors." H.R. Rep. No. 109-66 at 44 (2005). The rate regulation of competitive products was explicitly intended to serve as a complement to other provisions addressing fair conditions of competition. *Id*. at 46. *See also* S. Rep. No. 108-318 at 27-28 (2004) ("The Committee strongly believes that the Postal Service should operate more like a private business but, when competing head to head with a private business, we believe just as strongly that the advantages the Postal Service has as a government entity should be blunted").

> products cross-subsidizing the fixed costs of the stand-alone competitive enterprise. For this reason, *the appropriate share requirement is an important safeguard to ensure fair competition on the part of the Postal Service*. [Docket RM2012-3, Order No. 1449 at 13 (2012) (emphasis added)]

What, then, is the share of institutional costs that competitive products should cover in order to "represent the fixed costs of the competitive enterprise" of USPS and "reflect the ways in which institutional resources are spent on the competitive enterprise" so that the result is appropriate to the goal of ensuring "fair competition on the part of the Postal Service"? The Commission did not answer this question in 2012. Instead, Order No. 1449 pointed to the Commission's analysis of "appropriate share" five years earlier in Order No. 26, Docket No. RM2007-1, during the initial implementation of the PAEA.

Order No. 26, however, did not determine what share of institutional costs is "appropriate" to achieving the overall goals of the PAEA. While Order No. 26 concedes that the Commission has "an obligation to preserve competition by not establishing a markup so low as to give USPS an artificial competitive advantage" (¶ 3058), it sheds no light on how to meet that obligation. Order No. 26 merely says that the Commission considered several possible standards for "appropriate share" — equal unit contribution, equal percentage markup, markup of competitive products' attributable costs, and percentage of revenues — and "none these were deeded preferable" to requiring competitive products to contribute a static percentage of total institutional costs (¶ 3050). Instead of defining "appropriate share" by reference to the statutory objectives, Order No. 26 sought to preserve the status quo. The Commission set the share of institutional costs that must be covered by competitive products collectively at 5.5 percent of institutional costs, less than the level of "reasonably assignable" institutional costs established by the Commission in the previous rate case, 6.9 percent, and roughly equal to share of institutional costs achieved in the two years preceding the previous rate case (¶¶ 3052, 3059). Setting such a low bar for the contribution to institutional costs ensured that the "appropriate share" requirement would not require USPS to raise rates for competitive products because competitive products would not have to cover any more costs than they had before enactment of the PAEA. Thus, Order No. 26 did not establish what share of institutional costs is appropriate to implement to the new statutory scheme. Rather, Order No. 26 summed up its approach as follows: "at the outset of the new form of competitive rate regulation. . . . *the Postal Service should perform at least as well as it has historically*" (¶ 3060, emphasis added). Five years later, Order No. 1449 conceded as much, explicitly citing this language from Order No. 26. Order No. 1449 at 12.

At best, Order No. 26's implementation of the "appropriate share" standard was an initial, temporary solution that sought to avoid disruption of USPS's relatively small competitive operations at a time when USPS and the Commission were trying to implement a full menu of fundamental changes required by PAEA. But no one familiar with the history of the PAEA could interpret the "appropriate share" of section 3633(a) as a direction to the Commission to ensure forever the historic performance of USPS in competitive products markets. The vision that motivated the PAEA was both more dynamic and more commercially neutral. It is time to move past temporary initial measures designed to get the PAEA off the ground and to adopt an interpretation of "appropriate share" that is suited to the larger objectives of the legislation.

2 Implications of the rapidly changing market for postal services

The dominant fact of life for anyone involved in the delivery services market today is the rapidly changing the nature of the market. Electronic communications technologies have drastically reduced the volume of letters, the raison d'être of the national post office for more than a century and half. An explosion in e-commerce is propelling rapid increases in both the volume and the economic importance of the package services of USPS, private carriers, and increasingly, large retailers like Amazon. The center of gravity of USPS's operations is shifting from market dominant document services to competitive package services.

This trend is evident from the Commission's statistics. In 2007, competitive products accounted for 10.7 percent of total revenues and 13.5 percent of total attributable costs. Revenue from competitive products covered 5.7 percent of institutional costs. Only eight years later, in 2015, competitive products accounted for nearly a quarter (24.1 percent) of total revenues and almost a third (29.6 percent) of attributable costs. Revenue from competitive products covered 13.4 percent of institutional costs. By 2022, the date of the next mandatory review of the appropriate share of institutional costs to be allocated competitive products, competitive products could easily constitute the majority of revenues and attributable costs of USPS.

The evolution of the nature of postal services holds two basic implications for this docket. First, the new regulation should explicitly take into account the rapid and unpredictable development of the package delivery market. An institutional contribution by competitive products that is defined as a static percentage of total institutional costs is no longer workable. Second, as the Postal Service becomes an ever more important player in the national e-commerce market, it becomes ever more important that the new regulation is firmly grounded in an explicit concept of what share of institutional costs will implement what Senator Collins referred to as the "safeguards against unfair competition by the Postal Service in competitive markets."

3 Conceptual interpretations of "appropriate share"

Order No. 1449 framed the issue well: USPS's competitors incur fixed operating costs. If

USPS's competitive products were provided by a standalone enterprise, it too would incur fixed operating costs. The appropriate share requirement should establish the level of the fixed costs that USPS's competitive products must bear to ensure fair competition on the part of USPS. So, in principle, what is the minimal level of institutional costs that should covered by competitive products collectively? Conceptually, there appear to be three alternative standards.

Standalone cost standard

How should the accounts of USPS be organized to ensure that USPS does not enjoy "an artificial competitive advantage" (Order No. 26 at ¶ 3058) from its government-developed market dominant business? Just like USPS, a private company competing with USPS in the competitive products market incurs overhead costs — expenses of top management, legal and financial staff, data processing systems, facilities used for multiple products, etc. —that cannot be causally attributed to any specific product. The private company must necessarily earn enough revenue from its competitive activities to cover all of these overhead costs, or it will go out of business. A private company cannot rely on a government agency to pay for some of these overhead costs. If USPS were to compete with private companies on a completely level playing field, it would face the same discipline. It would be required to cover *all* of the non-attributable overhead costs necessary to provide competitive products from revenues earned from the sale competitive products. In short, the "appropriate share" of institutional costs that USPS's competitive products should bear to achieve a truly level playing field with private competitors is, in principle, all of the overhead costs necessary to operate the competitive products business as a standalone business.

What are the overhead costs of USPS that are necessary to operate its competitive products business? According to the Commission, in 2015 about 46 percent of the total costs of USPS, $33.8 billion, were fixed or “institutional” costs that do not vary with volume. Although institutional costs supposedly do not vary with volume, would USPS actually have to incur the same institutional costs if it provided its competitive products on a standalone basis? On its face, this seems excessive, but it is unclear from the Commission’s accounting what portion, if any, of the institutional costs would not be required to provide competitive products on a standalone basis.

Proportional attribution standard

A second approach to the “appropriate share” standard would be to require USPS to allocate the same proportion of institutional costs to competitive products as it attributes in attributable costs. If competitive products account for 30 percent of all attributable costs (at they did in 2015), then revenues from competitive products collectively must be sufficient to cover 30 percent of institutional costs as well, i.e. 30 percent of total costs.

In effect, under a proportional attribution standard the benefits of economies of scale and scope would be divided between customers of market dominant and competitive products proportionally. In providing competitive products, USPS is making of use of *institutional costs* — buildings, trucks, computer systems, transportation and network systems, administrative services, etc. —all (or at least a substantial portion) of which are necessary to the production of competitive products, yet only 30 percent of these common costs (in 2015) would be charged to competitive products. In addition, economies of scale and scope substantially reduce the *attributable costs* of producing competitive products. [2] Compared to the total cost of producing

[2] In a recent paper, Robert Cohen and John Waller estimated that in 2014 USPS saved about $5.6 billion in the delivery of domestic competitive products because it delivers almost all competitive packages in the regular mail

competitive products on a standalone basis, the reduction in production costs for USPS will continue to give USPS a substantial advantage in competitive markets.

Since institutional costs are common to both market dominant and competitive products, there is, by definition, no causal basis for deciding what is an “appropriate share” to allocate to competitive products. The only basis is public policy. The Commission must look to the overall goals of Congress and the general public interest to determine what share is “appropriate.” The proportional attribution standard is consistent what many regulators have historically considered to be fair and reasonable. If a government post office competes with private companies using the benefits of economies of scale and scope derived from government activities, then it seems fair and reasonable that customers of competitive products should contribute to the common costs in at least the same measure as customers of market dominant products. Fair, that is, to both the customers of both market dominant and competitive products. The customers of private competitors are still relatively disadvantaged because they do not share in the economies of scale and scope generated by USPS’s market dominant products.

It should be noted that by applying the proportional attribution standard to all competitive products collectively, the PAEA avoids the usual criticism that fully distributed cost pricing is uneconomically rigid. USPS faces that same market discipline as a private company. It is free to price some competitive products aggressively (down to attributable costs), but it must then

delivery, a 34 percent cost saving. Cohen and Waller concluded, “We have found that the cost of ordinary delivery for Competitive parcels is about 40 cents per delivered piece. Thus, the cost difference between ordinary delivery and stand-alone parcel route delivery is about $1.77 per parcel. The total number of domestic Competitive parcels was 3,167,836 thousand pieces in 2014. When we multiply the cost difference by the number of competitive parcels the total cost savings comes to $5,602 million.” Robert Cohen and John Waller, “The Postal Service’s Cost to Deliver Parcels on Letter Routes and Parcel Routes” at 15 (a paper presented at the Economics Conference on E-commerce, Digital Economy and Delivery Services,” Toulouse, March 31-April 1, 2016). See http://idei.fr/conferences/2016-ninth-bi-annual-postal-economics-conference-e-commerce-digital-economy-and-delivery-services. The authors have slightly revised this paper in ways unrelated to the references in the text, but the revised version has not been published.

recover its fixed costs by charging more on other competitive products.

In the development of the PAEA in late 1998 and early 1999, there was a vigorous debate about the share of institutional costs that should be borne by competitive products. The House Postal Service Subcommittee, the primary author of the legislation, first proposed a bill that would include a statutory requirement similar to the proportional attribution standard.

In Congressional hearings in February 1999, the Commission testified that it considered the version of the proportional attribution standard in the House bill to be a fair and reasonable approach:

> *The Commission also considers as entirely reasonable the proposition that competitive products should have at least the same cost coverage as all mail services combined*. Private sector firms must cover overhead costs and generate profits. *Competitive postal products should generate at least a proportionate contribution to the institutional costs* of the Postal Service. If the average contribution is so high that it reduces the Service's ability to compete effectively, either the Postal Service has excessive overhead costs, or the rates for monopoly products are too high and should be reduced. *There is no valid reason for captive customers to have to pay more toward overhead than users of competitive services*.[3]

The Antitrust Division of the Department of Justice similarly emphasized that "an equal proportional mark-up for institutional costs" was necessary to "place the Postal Service closer to an equal footing with its competitors":

> Under the legislation, price regulation on competitive products is limited substantially, requiring only that the prices established by the Postal Service cover the direct and indirect postal costs attributable to such products. *Competitive products collectively must bear at least an equal proportional mark-up for institutional*

[3] *H.R. 22, The Postal Modernization Act of 1999: Hearings Before the Subcommittee on the Postal Service of the House Committee on Government Reform* , 106th Cong., 1st Sess., at 149 (1999) (testimony of Edward J. Gleiman, Chairman, Postal Rate Commission) (emphasis added).

> *costs as do all non-competitive and competitive products combined. The rationale behind such a requirement — that the Postal Service should not be allowed to subsidize its competitive activities by loading up its overhead costs in the non-competitive category of products, for which it earns a guaranteed return — is a legitimate competitive concern of cross-subsidization.* At the same time, the intent of the legislation is that as long as the cross-subsidization is avoided, the Postal Service will have the same freedom to price its competitive goods and and services as its competitors. An important corollary to this structure is that the intent of the legislation is to subject the Postal Service to the antitrust laws for activities related to non-monopoly products.
>
> *This structure seems to place the Postal Service closer to an equal footing with its competitors with respect to competitive products.* It allows greater flexibility to the Postal Service while, at the same time, subjecting it to the same antitrust laws that its competitors face. It provides more pricing flexibility to the Postal Service while attempting to ensure that inappropriate subsidization does not occur.[4]

Although the statutory prescription proposed by the House Postal Service Subcommittee was later replaced a vaguer, more discretionary direction to the Commission ("appropriate share"), there was no retreat from the principle that, as the Commission put it in 1999, "competition between the Postal Service and private enterprises should be as fair as possible. . . . competition should take place on a level playing field."[5]

Incremental cost standard

A third approach to the "appropriate share" standard would be to eliminate any minimum allocation of institutional costs to competitive products. That is, the "appropriate share" would be set at zero percent of institutional costs.

The incremental cost standard was essentially the approach advocated by USPS in 1999

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[4] *Id*. at 322-23 (testimony of Donna E. Patterson, Deputy Assistant Attorney General of the Antitrust Division, Department of Justice) (emphasis added).

[5] *Id*. at 134.

(after a five-year transition). USPS argued that the requirement that competitive products must cover attributable costs and the application of the antitrust laws was sufficient to address the issue of the allocation of common costs.[6] However, this position was unpersuasive to either the House or the Senate. Attributable costs do not address the allocation of common costs. As the testimony of the Department of Justice made clear, the antitrust laws by themselves do not establish a guideline for the allocation of common costs in a state-owned enterprise that participates in both regulated and competitive markets.

The Mailers Coalition for Postal Reform, a coalition of standard class and package mailers, also opposed the allocation of common costs proposed in the Subcommittee bill. Its rationale was straightforward, "it is our understanding that current rates for competitive would have to increase by as much as 10 percent."[7] This self-interested reasoning is clear enough, but it does not identify what share of institutional costs is required by the "appropriate share" requirement of section 3633(a).

In short, the intellectual case for the incremental cost standard put forward in 1999 was weak. It is obvious that giving USPS carte blanche to participate in competitive markets while charging almost half the costs of production to captive customers in market dominant markets would bolster its commercial success. It is just as obvious that what is good for USPS does not establish what share of institutional costs is "appropriate" to the goals of the PAEA.

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[6] *See id*. at \88-90 (1999) (testimony of William Henderson, Postmaster General, and Mary S. Elcano, SVP and General Counsel, U.S. Postal Service). USPS's amendment and formal explanation is set out in an untitled submission to the House Postal Service Subcommittee with the heading "12/23/98 (Based on Committee Print as amended 09/24/98)." A copy of this document will be provided upon request.

[7] *See H.R. 22, The Postal Modernization Act of 1999: Hearings Before the Subcommittee on the Postal Service of the House Committee on Government Reform* , 106th Cong., 1st Sess., at 373 (testimony of Jerry Cerasale, SVP Government Affairs, Direct Marketing Association, on behalf of the Mailers Coalition for Postal Reform).

4 Position of FedEx

FedEx participated actively in the development of the PAEA and is firmly convinced that one of the key objectives of that legislation was to establish, as nearly as possible, "a level playing field" in the market for competitive products. In competitive markets, USPS should face the same financial and legal risks as a private competitor. There should be no governmental thumb on the scale of competition nor a guarantee of commercial success for USPS. The "appropriate share" language of section 3633(a) can only be interpreted as referring to the share of institutional costs that is best suited to achieving this broad policy objective.

Conceptually, the correct standard for allocation of common costs appears to be the standalone cost standard. Put another way, the fairest and soundest approach to USPS's development of competitive products might be for USPS to establish a separate division that purchases collection and delivery services from USPS on an arm's length basis. That way, all of the common costs associated with competitive products would be readily identifiable. However, although this might be a useful concept to consider in future structural reform of USPS, applying a "standalone cost standard" to the institutional costs of USPS as currently constituted appears to be very difficult if not impossible.

For this reason, FedEx urges the Commission to adopt the proportional attribution standard as the most feasible and reasonable interpretation of the "appropriate share" requirement of section 3633(a). Unlike the standalone cost standard, the proportional attribution standard is straightforward, flexible and easy to administer. Although the proportional attribution standard will not create not a perfectly level playing field — USPS will retain very substantial competitive advantages due to economies of scale and scope between market dominant and competitive products — it will nonetheless require USPS to allocate a fair and reasonable share of institutional costs to competitive products. Unlike the fixed standard adopted in 2007, the proportional attribution standard will increase or decrease the level of institutional costs allocated to competitive products as the volume of competitive products increases or decreases. In that way, the playing field will become more level as the proportion of competitive products rises compared to market dominant products and raises the share of institutional costs borne by competitive products. FedEx supported the proportional attribution standard throughout development of the PAEA.[8] It still seems the best approach in principle.

Respectfully submitted,

Nancy S. Sparks
Managing Director, Regulatory Affairs
Federal Express Corporation

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[8] See *id*. at 335-72 (testimony of Frederick W. Smith, Chairman and CEO, FDX Corporation).